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May 7, 2007

Mr. Winston Hickox, Chairman
CalEPA Market Advisory Committee
Via e-mail: climatechange@calepa.ca.gov

Dear Chairman Hickox and Committee members:

On behalf of Environment California's tens of thousands of citizen members across the state, we would like to thank the Market Advisory Committee (MAC) for giving the opportunity to offer suggestions for the appropriate role, scope, and structure of a cap-and-trade program in California.

The Market Advisory Committee's (MAC) service is an important resource for the California Air Resources Board (CARB) as they decide if and how to utilize market programs to meet the state's emissions reduction requirement under the California Global Warming Solutions Act of 2006 (AB 32, Núñez/Pavley). We were grateful for the opportunity to offer written comments at your February 27th public meeting and are equally appreciative for the opportunity to offer a lengthier overview of our perspective.

While a cap-and-trade program is not cure-all for global warming, if well designed, we believe such a program can be an important part of California's effort to reduce greenhouse gas emissions. We believe the following principles are among those that should guide the state as it designs a potential cap-and-trade program for use in California:

1. **Make polluters pay**
2. **Ensure the cap has integrity (price caps, offsets, leakage)**
3. **Protect public health**
4. **Develop a comprehensive program**

Make polluters pay

The "polluter pays" principle holds that polluters, rather than the public, should pay the costs imposed by their pollution on others. Of course, global warming pollution imposes huge costs on other elements of society – costs that are not currently paid by the polluter.

The "polluter pays" principle is relevant to the structural decision of how to distribute allowances, specifically whether pollution allowances should be given to polluters for free or sold to polluters through an auction. Environment California supports auctioning all emission allowances. We believe forcing polluters to pay through an auction is a superior approach to freely distributing them for four main reasons, which we respectfully request the MAC report to address.

First, we believe auctioning allowances is fair. California's air is a commonly held resource to be managed for the benefit of the public. As a result, it is fair to require polluters to compensate the public for use of that resource. Auctioning would also be fairer because it removes the potential for favoritism in the distribution of free allowances and further market distortion.

Second, there is strong evidence that auctioning would ultimately be less costly to society than free distribution and will prevent windfall profits. For example, a study by Resources for the Future estimated that an auction and revenue recycling approach was roughly half as expensive as an allocation system based on "grandfathering" of existing emitters.[1]

Third, auctioning would play an important role in helping California transition to a clean energy economy. While giving allowances away for free – particularly when they are distributed on the basis of past emissions – rewards owners of highly polluting facilities and discourages innovation, auctioning allowances treats all emitters – dirty and clean facilities and existing and new facilities – equally. By placing all emitters on a level playing field, we believe California can more rapidly transition to cleaner sources of energy.

Finally, auctioning would provide important public benefits for our state. The establishment of a cap-and-trade program in California would create emissions allowances likely worth hundreds of millions of dollars. Giving polluters allowances for free would allow polluters to financially benefit from the program. On the other hand, an auction enables the state to use revenue from the sale of allowances for a variety of important public purposes including investments in energy efficiency, investments in clean energy research and development, deployment of renewable energy technologies, and annual rebates to consumers.

Ensure the cap has integrity (price caps, offsets, leakage)

The central feature of a cap and trade program is the creation of an overall, quantitative limit on emissions that can be enforced on emitters by requiring allowances. Cap-and-trade can only be a useful tool for achieving our reduction goals if ensuring the integrity of the cap is the paramount priority. We request that the MAC report address ways that the environmental integrity of a cap-and-trade program can be protected, such as avoiding price caps, limiting offsets, and preventing leakage.

Environment California is opposed to any price cap or other safety valve because such a mechanism would fail to guarantee that the level of emissions reductions called for in a program would actually be achieved. In addition, a safety valve would shift costs into the future and put a greater burden on future generations that are sure to face daunting challenges in mitigating and adapting to a changing climate.

Similarly, Environment California believes offsets provide less-certain reductions in emissions, thus eroding the environmental integrity of any potential program. The essential problem is that

[1] Dallas Burtraw, Resources for the Future, "Carbon Emission Trading Costs and Allowance Allocations: Evaluating the Options," *Resources*, Fall 2001.

allowances represent units of *pollution emitted*, whereas offsets represent units of *pollution not emitted*. To determine whether an emission reduction achieved through an offset is equivalent to an allowance, one must know not only how much pollution was emitted from the source providing the offset, but how much *pollution would have been emitted* had the offset not been issued. Accurate accounting for many offsets is thus extremely difficult, if not impossible. To the extent that offsets would be allowed, we urge the MAC to address the importance of having strict protocols for demonstrating validity and integrity of offset emissions, and to take into consideration the statutory requirement under AB 32 that emissions reductions be "real, permanent, quantifiable, verifiable, and enforceable by the [CARB]."[2]

Finally, Environment California believes that the integrity of any cap would need to be protected by designing a potential trading program to minimize leakage of emissions to sources outside of California. Leakage is a particularly big problem for a cap on power plant pollution given that our regional electricity grid crosses state lines and that we already import one-fifth of our electricity supply. Given this predicament, we support the establishment of a load-based cap on the utility sector as opposed to a generator-based cap so that that emissions from imported electricity are treated the same as emissions from electricity generated within California.

Protect public health

In light of the fact that California faces incredible challenges in reducing criteria and toxic air pollutants that negatively impact public health, Environment California believes the state should prioritize policies that bring complimentary gains in both public health and greenhouse gas emissions. Furthermore, the CARB is required to "consider overall societal benefits, including reductions in air pollution… and other benefits to… public health" in designing regulations to meet the statewide cap and, more specifically, ensure that market-based compliance mechanisms "prevent any increase in the emissions of toxic air contaminants or criteria air pollutants."[3] We urge the MAC to consider California's unique public health concerns, as well as the regulatory requirements on the CARB, and explore the best way for a cap-and-trade program to make reductions in greenhouse gas emissions while simultaneously improving public health.

This issue is very relevant to decisions the state must make about the kinds of limits to place on the use of offsets. Obviously, allowing the use of offsets that are generated outside California would reduce the amount of emissions reductions that occur within the state. Given that many of the largest emitters of greenhouse gas emissions are also among the largest emitters of health-threatening air pollution, allowing out-of-state offsets reduces the potential for climate policy to drive simultaneous improvements in air quality. Indeed, allowing out-of-state offsets would result in California consumers paying in many instances for investments to improve industrial and energy systems in other states and nations – investments that otherwise would have been made in California.

The need to protect public health also relates to the issue of whether to require polluters to pay for allowances. It is likely that revenue from an auction would be an important tool to ensure a cap-and-trade program generally advances clean air goals and, more pointedly, the statutory requirements of

[2] Health and Safety Code, Division 25.5, Section 3862 (d)(1)
[3] Health and Safety Code, Division 25.5, Section 38562 (b)(6); Section 38570 (b)(3)

AB 32 which require no backsliding on emissions of toxic and criteria air pollutants and due consideration to maximizing public health benefits.

Develop a comprehensive program

In developing your recommendations for what sectors and design features a potential trading program in California might include, Environment California asks the MAC to consider the other greenhouse gas strategies California is likely to employ, the co-benefits of those alternate strategies vis-à-vis a trading program, and the way those strategies might interact with a trading program. We believe a key principle to designing an effective potential cap-and-trade program is acknowledging that supplementary policies are needed – regardless of whether California adopts a trading program – to ensure that emission reductions occur at the lowest possible cost and provide the greatest complementary benefits to the public and the economy.

Because there is no "silver bullet" policy solution to a problem as complex as global warming, the state will need to use multiple tools – including regulation, taxation, public-sector investment, and market-based systems – to achieve greenhouse gas reductions. California has a robust history of using effective command-and-control measures to promote clean air and clean energy that should be expanded upon to reduce greenhouse gas emissions. Regulatory measures such as efficiency standards for vehicles and equipment, building codes, renewable energy standards for electricity generation, greenhouse gas performance standards for electricity generation and transportation fuels, and incentives for deployment of promising technologies are among the policies that be prioritized as part of California's overall global warming program.

Beyond considering effective regulatory measures, Environment California urges the MAC to clearly address the limitations that a trading program would present for certain sectors. For example, Environment California believes that sectors such as transportation might benefit less from a cap-and-trade program compared to other sectors because it is difficult to regulate entities within the transportation sector that can make investment decisions to directly reduce future emissions.

To elaborate, within the transportation sector oil refineries are a likely point of regulation because emissions can be measured relatively easily and inexpensively (compared to automobiles, for instance). Unfortunately, oil refineries have few ways to influence carbon dioxide emissions from the products they sell. They cannot force automakers to produce less-polluting cars, nor can they invest in transit infrastructure that would make it more convenient for drivers to leave their cars at home. Consequently, in the absence of public policy that provides consumers with sufficient options for fuel-efficient vehicles and quality transit service, requiring oil refineries to hold allowances in a trading program would not adequately reduce emissions within the transportation sector, but would result in costs being passed down to consumers, who in turn would perceive the cost as a tax on energy. (On the other hand, the results are more promising in the electricity sector, where if electric utilities were required to hold emission allowances they would likely respond by investing in energy efficiency programs and purchasing more power from renewable electricity generators.)

We hope the perspective presented in this letter is useful to the MAC as you formulate your recommendations on how a cap-and-trade program could potentially be established in California. We appreciate the time, energy and expertise that each of you has devoted to this endeavor.

Sincerely,

Jason Barbose
Global Warming Advocate
Environment California

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